

TO: Files

CC: San Diego Audit Committee

FROM: Willkie Farr & Gallagher LLP

RE: Interview of Councilmember Donna Frye on May 3, 2006

DATED: May 27, 2006

On Wednesday, May 3, 2006, Benito Romano, Michael Schachter and Heath Rosenthal, in Willkie Farr & Gallagher's capacity as counsel to the Audit Committee, interviewed Council member Donna Frye. Councilmember Frye was represented by counsel, Marco Gonzalez of the Coast Law Group. Also in attendance were Troy Dahlberg of the Audit Committee, William Haegele and Donielle Evans of KPMG. The interview took place in Councilmember Frye's office in the San Diego City Administration Building and lasted approximately three hours.

The following memorandum reflects my thoughts, impressions and opinions regarding our meeting with Councilmember Frye, and constitutes protected attorney work product. It is not, nor is it intended to be, a substantially verbatim record of the interview.

Warnings

At the outset of the interview, Mr. Romano clarified the circumstances and purpose of the City of San Diego's (the "City") creation of the Audit Committee, noting that information obtained during the course of the interview would be used, if relevant, in an analysis in the Audit Committee's eventual report. Mr. Romano explained although the matters discussed during the interview would be treated as confidential, and may be covered by either the attorney-client privilege or the work product doctrine, in the likely event that the Audit Committee issues a report, the privilege will be lost. In addition, the City can waive the privilege even if no report is issued. Mr. Romano asked that Councilmember Frye keep the discussions had during the interview confidential. Mr. Romano explained that, if requested, we would provide information from the interview to the SEC, the U.S. Attorney's Office or the City's outside auditor, KPMG, so it is important that Councilmember Frye be accurate and truthful. Mr. Romano emphasized that Councilmember Frye could seek clarification of any question at any time.

Background

Mr. Romano asked Councilmember Frye to tell him about how she came to be on the Council. Councilmember Frye stated that she is currently a member of the City Council, representing the 6th District of San Diego. She was elected to the City Council in a special election in June 2001. Mr. Romano asked Councilmember Frye if she received any training after she was elected. Upon taking office, Councilmember Frye was provided with a City Orientation

Council Member Notebook from 2000 to read. That notebook, which was her only form of training, contained sections discussing the Municipal Charter, conflict of interest issues, the Ethics Ordinance and other topics. She has served on all of the Council's committees, with the exception of the Rules Committee. In discussing her role on the Council, Councilmember Frye explained that prior to the implementation of the strong Mayor form of government, Council members could not call City staff directly. The San Diego Charter provided that Council only has authority to direct the City Manager to perform.

Budget

Mr. Romano asked Councilmember Frye about the process by which she reviews the annual budget. Councilmember Frye explained that when she was first elected to the Council in June 2001, she met with the City Manager who provided her with all of the budget documents. She had only one week to review these documents and vote on the budget, and she was not provided with any other help to prepare her for this task. Mr. Romano then asked Councilmember Frye to explain the process by which the budget gets approved. Councilmember Frye explained that in October, the City Manager reports to the Council on the budget and the Council directs the Manager about what it wants to be included in the budget. No report is issued at that time. In April or May, the Council is provided with binders relating to the budget, and a few hours later the City Manager does the ceremonial "roll out" of the budget. Mr. Romano asked whether the budget included future projections. Councilmember Frye responded that projections of the impact of the budget for years after the budgeted year are not included.

Ballpark Bonds and the Bryan Cave Memorandum/Presentation

Mr. Romano showed Councilmember Frye Exhibit 1, a November 6, 2001 memorandum from Les Girard (Executive Assistant City Attorney) to the City Council that attached a letter from the Bryan Cave law firm to Mr. Girard, dated October 29, 2001, and asked her if she recalled the letter. Councilmember Frye stated that she remembered that the letter was discussed in closed session by lawyers, but she did not recall exactly who gave the presentation. She explained that the presenting attorney told the Council that the closed session arose because of litigation that already had been filed and a possible lawsuit that might be filed by a Mr. Henderson in relation to the issuance of the Ballpark bonds, and that the Council had to be very careful to avoid such a lawsuit. The Bryan Cave letter did not state what the Council's disclosure duties were. Councilmember Frye stated that Mr. Girard provided the Council in closed session with questions to ask in open session in order to help avoid litigation relating to the Ballpark bonds.

Mr. Romano then asked Councilmember Frye how she prepared for the vote on the Ballpark bonds. Councilmember Frye explained that she read the Preliminary Official Statement ("POS") and the City Manager's report in connection with the POS. Mr. Romano asked whether Councilmember Frye read the POS for accuracy. She stated that the POS was massive and difficult to read, but she tried to make sense of it. She did not read the POS for accuracy because she assumed that the numbers were checked by the accountants and lawyers involved with its drafting. Councilmember Frye did not have help understanding the POS.

Although Councilmember Frye stated that she sent her original marked-up copy of the Ballpark POS to the F.B.I., she showed Mr. Romano a copy of the document marked-up.¹

Mr. Romano asked if Councilmember Frye asked any of the questions provided to the Council by Mr. Girard. She answered that she asked her own questions during the Council meetings in which the Ballpark bonds were discussed, but not the ones provided by Mr. Girard. However, Councilmember Frye said that Mayor Dick Murphy would tell her to "take her questions off the line," or in other words, ask it outside of the meeting. Councilmember Frye said that it was her practice to ask a lot of questions, and it was not uncommon for Mayor Murphy to be dismissive of her inquiries. Councilmember Frye believed that because the Ballpark bonds had been the topic of discussion for quite some time prior to her taking office, no one wanted to entertain her questions. As a result, she had to seek out answers from the City Attorney's Office.

Councilmember Frye went on to state that she voted against the approval of the Ballpark bonds. She believed that the Ballpark would be more expensive to build than she was being told it would. Councilmember Frye added that Mayor Murphy held numerous press conferences on the Ballpark bonds during which his story about the Ballpark constantly changed. The Ballpark bonds were approved, and Councilmember Frye believed that this was a done deal before it ever went to vote before the Council.

Disclosure

Mr. Romano asked Councilmember Frye if she reviewed other disclosure documents as carefully as she did the Ballpark bond disclosure documents. Although Councilmember Frye said that she believes it is her responsibility as a Council member to read all of the documents she receives. However, aside from the Ballpark offerings, she did not feel that she had to look carefully at any other offering or TANS. On that note, she said that she did not know when the CAFRs were issued and she probably has only seen one. Moreover, Councilmember Frye stated that when she reads these disclosure-type documents, she does not look at the accuracy of the numbers or the facts cited therein. However, she does believe that Council members should be responsible for understanding financial documents to a reasonable degree.

Later in the interview, Councilmember Frye briefly described an incident in which City Manager Michael Ueberuaga became uncharacteristically angry with former City Auditor Ed Ryan. She believed this resulted from Mr. Ryan's decision to retract a recently released Wastewater POS due to errors and his statement that this was nothing to worry about.

Blue Ribbon Committee Report

Mr. Romano asked Councilmember Frye if she recalled reading the Blue Ribbon Committee ("BRC") Report. Councilmember Frye stated that she did read the BRC Report and raised a fuss about it because it made false declaratory statements regarding stormwater.

¹ Councilmember Frye maintains that document in her office.

Consequently the stormwater part of the BRC Report was not approved by the Council. Mr. Romano then asked Councilmember Frye her thoughts on the BRC Report's discussion of the pension underfunding. Councilmember Frye said that she did not see the pension issue as alarming at that time; she was more concerned with the stormwater issue because she understood it. She believed the BRC Report to be a political stunt. In response to Mr. Romano's question, Councilmember Frye said that she did not learn from the Council members on the Rules Committee how the CERS (San Diego City Employees Retirement System) responded to the BRC Report.

MP2

Mr. Romano asked Councilmember Frye when she first learned about MP1; she could not recall. Mr. Romano then asked her when she recalled that benefits were being linked to the City's contribution rate relief. Councilmember Frye stated that the link between the benefit increases and the rate relief to the City was not clear to her in 2002. What stood out in her mind about the November 18, 2002 Council meeting in which MP2 was approved was her own request that the sewer Cost of Service Study ("COSS") be released and the discussion of providing \$300 million for a library, which was part of Mayor Murphy's "ten goals." The Chargers were also a huge issue at the time. Similarly, she did not recall the pension as being the predominant issue in the Spring 2002 Meet and Confer. To refresh her recollection, Mr. Romano showed her Exhibit 2, a June 14, 2002 memorandum from Cathy Lexin (Human Resources Director) and Elmer Heap (Head Deputy City Attorney) to the Mayor and Council. She still did not recall any Council member or Mayor Murphy stating out loud that the granting of benefits was contingent upon the City's contribution rate relief. Mr. Romano asked Councilmember Frye if any of the Council members had a strong political interest in the issue of the benefits that were being negotiated for at the time, and she stated that her sense was that they did not.

Councilmember Frye then added that the terms of MP2 were presented to the Council in a manner that was way too complex to comprehend and that frustrated her. Councilmember Frye stated that she did not believe that MP2 is complicated, but because nobody took the time to explain it, MP2 confused her. Councilmember Frye believed that the City Attorney's Office and bond council should have helped the Council understand MP2 better. Councilmember Frye did not recall anyone warning her about the legalities of MP2; she could not understand MP2's implications at the time because she is not an attorney, an accountant, or an actuary.

Mr. Romano asked whether Councilmember Frye saw a problem with granting indemnification to the CERS Board. Councilmember Frye responded that she did not think that granting indemnification to the CERS Board was unusual: she had been indemnified by the City when she served on the Community Planning Group. Mr. Romano then showed Councilmember Frye Exhibit 3, the July 8, 2002 memorandum from Ms. Lexin and Mr. Heap to the Mayor and Council in which it was indicated that Ms. Lexin and Mr. Heap anticipated a motion from a Board member to modify the MP2 proposal and asked her whether this indicated their advance knowledge that a motion would be made. Councilmember Frye agreed that it seemed as if the knowledge that a motion would be made was present, but she stated that was not out of the ordinary.

Mr. Romano asked Councilmember Frye how she came to know Diann Shipione (CERS Board member). Councilmember Frye stated that she knew of Ms. Shipione's husband, Pat Shea, because he testified in the Brown field hearings and because he was associated with Mayor Susan Golding's "inner-circle." However, Councilmember Frye did not know of Ms. Shipione until Ms. Shipione stood in front of the Council and told them not to vote for MP2. Although Board member Ron Saathoff testified after Ms. Shipione and stated that all was satisfactory with MP2 and others said that Ms. Shipione was a "wing nut" who did not know what she was talking about, Councilmember Frye still wanted to know whether Ms. Shipione's allegations were true. The response to Ms. Shipione at the Council meeting was "yeah, yeah, move on and vote." Mr. Romano asked Councilmember Frye how Ms. Shipione appeared when she spoke to the Council, and Councilmember Frye said that Ms. Shipione appeared nervous. Councilmember Frye then explained that she empathized with Ms. Shipione because she herself asked questions frequently at Council meetings and was often told to take her questions outside of the meetings. Mr. Romano showed Councilmember Frye Ms. Shipione's November 18, 2002 letter to Mayor Murphy and the Council and asked if it was handed out at the Council meeting. Councilmember Frye could not recall, but she did remember thinking that Ms. Shipione's letter was a warning. Mr. Romano then showed Councilmember Frye Exhibit 4, Lamont Ewell's (Assistant City Manager) December 6, 2002 response to Ms. Shipione's November 18, 2002 letter and asked her opinion on that letter. Councilmember Frye stated that Mr. Ewell's letter did not sway her opinion that something was wrong with MP2. Mr. Ewell told her that he wished he had never signed that response. Mr. Romano also showed Councilmember Frye Exhibit 5, Ms. Shipione's December 31, 2002 letter reply to Mr. Ewell, which Councilmember Frye said was confusing to her, though she did not explain how.

Post-MP2

Mr. Romano showed Councilmember Frye Exhibit 6, a May 5, 2003 letter from City Manager Uberuaga to Councilmember Frye and Councilmember Jim Madaffer responding to their request for an independent audit of CERS. Councilmember Frye explained that she had attempted to get an independent audit of CERS in the Spring of 2003, but her efforts were not met with success. When Councilmember Frye went to the CERS Board to discuss the need for an independent audit, Board president Fred Pierce told her that the CERS Board already was conducting an audit. Councilmember Frye said that the problem was that such an audit was not independent. However, she did not push the issue any further because she did not feel that the rest of the Council fully supported her. She noted that although Councilmembers Madaffer and Brian Maienschein had also asked for an audit of CERS, because they had not supported her efforts to get Ms. Shipione appointed to the Pension Reform Committee ("PRC") that was formed in 2003 to investigate the pension issues, she believed that they would not help her any further with the audit issue. She also noted that neither the Council nor the Mayor was helping her get Ms. Shipione appointed to the PRC.

Mr. Romano asked Councilmember Frye when she learned that the pension underfunding was a large problem. Councilmember Frye said that she learned of the gravity of the pension underfunding through the 2004 report of Vincent & Elkins ("V&E") and it surprised her. She said she would have expected the City Attorney to keep the Council informed of the law and the City Manager, who had been gloating about the triple A rating of the City at the time, to tell the Council the truth. She also mentioned her anger over Teri Webster's infamous

"EEEK" email, noting that all Ms. Webster had to do was make one simple sentence to those who voted on MP2 about the truth of what was occurring in order to avoid the problems faced by the City today.

Purchase of Service Credits

Mr. Romano showed Councilmember Frye Exhibit 7, a March 5, 2003 email from Judy Folsom to Lawrence Grissom in which Ms. Folsom stated she would be meeting with Councilmember Frye on the issue of the purchase of service credits ("PSC"). Mr. Romano asked about the reference to PSC and whether Councilmember Frye recalled the a meeting with Ms. Folsom. Councilmember Frye explained that this email was referring to her own service credits, but she did not recall a meeting with Ms. Folsom. Councilmember Frye explained that she purchased service credits because, at the time, it was a normal method for saving. In fact, prior to her PSC, Councilmember Frye had a person from CERS come to her office and explain to her the benefits and process of making such a purchase. Councilmember Frye explained that she purchased her service credits through a combination of a lump-sum payment and monthly payments pursuant to a contract.

Councilmember Frye went on to state that once she learned that employees were not paying a high enough cost for their purchased service credits to cover the benefits they were receiving, she tried to get her money back. It took months for CERS to return the money she had paid pursuant to the contract, and it still has not repaid her lump-sum payment. Councilmember Frye was told that she cannot get her lump-sum payment back because the IRS looks at these funds as being commingled. She pointed out that it took someone on her staff only five minutes to get a PSC refund. Councilmember Frye believes that she got her contract payments back the week prior to the election in the previous mayoral race in which she was a candidate because someone wanted to place her in a bad light.

Wastewater

In the middle of the interview, Councilmember Frye stated that she saw all of the issues relating to the problems with wastewater and cleanwater come together in 2002. Mr. Romano asked her to explain. Councilmember Frye stated that prior to November 2002, the Council voted in closed session to exclude from the public a sewer COSS, and this angered her because she knew that the COSS concluded that residential users were being overcharged and were therefore subsidizing businesses. Mr. Romano asked Councilmember Frye how she knew what the conclusions of the COSS were. She stated that she learned this from a stakeholders group formed by Mayor Golding years before to follow this issue. Councilmember Frye recalled Mayor Murphy saying that the COSS would not be released, but she could not remember his reasoning. Councilmember Frye said that this was a poor decision that has caused the litigation faced by the City today.

Mr. Romano asked Councilmember Frye what would have caused the Mayor to hold back the COSS Report. Councilmember Frye responded that "the business owners would have to pay more money" and that this could have affected Mayor Murphy's re-election. Mr. Romano asked if Councilmember Frye knew at the time whether the City was in compliance with state law regulating sewer rates. She did not know. Mr. Romano asked her if her focus at the time was the inequity in the rate structure. Councilmember Frye responded that she gets

extremely agitated when public documents are not released and expressed her belief that people living in residences were being taken advantage of. Mr. Romano showed Councilmember Frye Exhibit 8, a closed session report from January 29, 2002, in which it is indicated that the City Attorney would "note and file" an issue discussed that day. Councilmember Frye confirmed that was the meeting in which she became angry because of the failure to release the COSS. In fact, Councilmember Frye recalled becoming so angry that she stood up at the meeting. She believed that Councilmember George Stevens probably stood up also. Councilmember Frye later stated in her interview that either Mayor Murphy, Richard Mendes (Deputy City Manager) or George Loveland (Deputy City Manager) told her that the COSS did not exist and therefore she decided to ask for it at a public hearing. She also said that noting and filing meant that the COSS would not be released unless it had to be.

Councilmember Frye further explained that on November 18, 2002, she gave the City Attorney a request to release the COSS to her. She stated that Mr. Ewell was infuriated by her request because the Mayor did not want it released. As a result, Councilmember Frye felt that Mr. Ewell treated her unkindly and with a lack of respect. Mr. Gonzalez commented that many people in City government at the time did not appreciate Councilmember Frye, a former environmental activist, poking around this issue. Councilmember Frye continued, stating that she did get a copy of the COSS a few days later on November 22, 2002. She wanted to file the COSS publicly, but the City Attorney's Office told her that the information contained in it was out of date and there was nothing that could be done about it.

Mr. Romano followed up by asking Councilmember Frye some questions about specific documents. First, he asked her about Exhibit 9, a memorandum from Richard Mendes (Deputy City Manager) to her on April 18, 2002 regarding Cost-of-Service Reports. Councilmember Frye said that she most likely requested the two 1998 COSS to obtain the rates the City charged for development. Next, Mr. Romano showed Councilmember Frye Exhibit 10, a November 14, 2002 memorandum from Mary Vattimo (City Treasurer) and Kelly Salt (Deputy City Attorney) to the Mayor and Council directing the City Manager to perform and implement the findings of a sewer rate COSS and to bring such rates into compliance with the federal grant and state loan requirements. Councilmember Frye agreed that this topic was discussed at a closed Council session. She recalled that around this time she wrote a letter to the City Attorney about her concern related to discussing the COSS in closed session. The City Attorney responded to her, and the matter did not get discussed at closed session. Mr. Romano next showed Councilmember Frye Exhibit 11, a November 18, 2002 letter from herself to Casey Gwinn (City Attorney) and Exhibit 12, a letter from Mr. Girard to her on the same date and asked if these were the correspondence about which she had spoken. Councilmember Frye confirmed that they were, and then said that although the City Attorney's office knew that the COSS was supposed to be released and that it would cause an increase in the rates, she was unsure if they knew the relation of the COSS to the State loans. Councilmember Frye added that she did not know who to go to for help; because she thought something was wrong and wanted a matter placed on the docket, she concluded it was appropriate to go to the City Attorney. Councilmember Frye did not recall who took her memorandum off the closed session agenda.

Mr. Romano then asked Councilmember Frye if she recalled seeing Exhibit 13, a November 26, 2003 letter from the State Water Resources Board ("SWRCB") to the City seeking documentation of the implementation of a SWRCB-approved wastewater rate structure.

Councilmember Frye stated that she remembers someone passing her this letter in February 2004. She explained that a lot of people "passed" her letters relating to Wastewater because it was known that she was concerned about that issue. She also stated that around the same time, she learned about the FBI and SEC raids and she had an "epiphany." At a closed session that month, the Council was introduced to Paul Maco of V&E to discuss his employment with the City. Mr. Romano asked if disclosure counsel Paul Webber was also present at that meeting; Councilmember Frye believed that he was. She said that after the closed session, she showed either Mr. Maco or Mr. Webber the November 26, 2003 letter and told them it had to be disclosed. Subsequently, she made the same recommendation to City Manager Uberuaga, but she did not recall his response. After these requests, Mr. Mendes came into Councilmember Frye's office looking for her and was agitated. Nevertheless, after Councilmember Frye recommended to a Mr. Smith and Mr. Mendes that the November 26, 2003 letter be disclosed, it appeared in the Voluntary Disclosures. Councilmember Frye stated her belief that the SWRCB actually would come into the City and force it to comply with the State rate structure.

Mr. Romano told Councilmember Frye that he had heard that sewer rates could not be increased in 2002 because the water rates had been raised already. Councilmember Frye said that the Council had been told that if it were to raise sewer rates at the time it would be subject to litigation. However, Councilmember Frye said that sewer rates were not raised as a result of political motives and not because the water rates had been raised. Mr. Dahlberg asked if the City Manager would know about the issues with the sewer rate increases on his own. Councilmember Frye responded that he would not, and stated that the City Manager would have to get directions from someone in the Wastewater Department or from the Mayor. Mr. Schachter asked Councilmember Frye when she received a finalized COSS. She responded that she received a COSS in 2003, but she was unsure at the time if it was finalized.

Mr. Romano asked whether Councilmember Frye knew if the companies Kelco or ISP were supporters of any elected official. Although Councilmember Frye was unsure, she did say that neither company was a supporter of hers and that she believed that they made independent expenditures for Mayor Murphy and possibly Richard Duvernay (Deputy City Attorney). She claimed that those companies ran an independent expenditure campaign against her in 2004 through a mailing carried out by the company Kepac.

Councilmember Frye also mentioned a memorandum written by David McKinley, an original member of the COSS Stakeholders Group, that had been brought to her. She explained that Mr. McKinley worked for ISP, a company that, because it discharged a lot of kelp, would have to pay higher rates if the State rate structure had been implemented. Thus, Mr. McKinley was opposed to using the analysis the state wanted to implement for rate charges based on COD (cal oxygen demand). The letter said that Mr. McKinley wanted to prevent the COSS and that Councilmember Byron Wear would carry the mantle for such prevention. Although Councilmember Frye recalled Mayor Murphy being vocally opposed to the COSS, she had no recollection if other Council members were. She did recall, however, that when it was stated in a Council meeting that "if we are out of compliance let them sue us," the room, with the exception of Councilmember Stevens, was cavalier. Councilmember Frye stated that Mayor Murphy eventually did raise the rates, but only because he had been "forced into a corner." However, the water rates were changed only with respect to proportionality because those rates

did not have to be adjusted in any other manner. Councilmember Frye stated that there had been a lot of "wheeling and dealing" at the Council meetings with regards to rate changes.

Remediation

Mr. Romano asked Councilmember Frye for her suggestions on how to improve the City's governance so that the problems faced by the City today do not reoccur. In general, Councilmember Frye said that she thinks the Council members need better training. She also stated that she does not believe that the Independent Budget Analyst is truly independent, and she would like to see someone who has no connection to City Hall audit the budget. According to Councilmember Frye, those who claim that San Diego's budget is satisfactory now are in denial. Councilmember Frye also suggested possibly mirroring the way in which the State legislature or the Attorney General's Office monitors their own budgets.

To better prepare for closed session, Councilmember Frye stated that she would like more time to review the documents being discussed and a summary in plain English (*i.e.*, without jargon) about the issues that will be the subject of the closed session. For disclosure issues, Councilmember Frye stated that she would like an explanation of what the Council's duties are and the interrelation of the CAFR, bond offering documents, and other financial documents. She would also very much like a report that lists the documents that were considered and the conversations that were had in the preparation of the disclosure documents.

WF&G

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